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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

January 23, 1995

William F. Caton, Secretary
Federal Communications Commission
1919 M Street, N.W., Room 222
Washington, DC 20554

Re: CC Dkt. No. 94-1 (Ex Parte Filing)

Dear Mr. Caton: DOCKET FILE COPY ORIGINAL

We write as managers of large corporate telecommunications networks in order to urge that the Commission make two important changes in the so-called "price-cap" regulations that apply to local exchange telephone companies ("LECs"). We believe these two changes will lead to lower priced communications service for all customers, including our companies.

In 1990, the FCC changed the way it regulates LEC communications service by substituting "price cap" regulation for "rate of return" regulation.[1/] In theory, "price cap" regulation is a regulatory approach under which the price of communications service is regulated directly. By contrast, "rate of return" regulation is a regulatory system under which price is regulated indirectly by controlling profit.

Unfortunately, we believe two features of the FCC's existing LEC price cap rules keep prices of communications service artificially high. First, although existing rules provide an incentive for LECs to lower prices by relatively small amounts by allowing LECs to keep increased profits that result from relatively small reductions in their operating costs, the rules discourage large price reductions by prohibiting LECs from keeping any profits that may result from such large price reductions. The rules produce this negative result by prohibiting LECs from earning <u>any</u> return on investment that exceeds 16.25 percent and by allowing them to keep only half of their profits between 12.25 percent and 16.25 percent. As a result, although LECs may have an incentive to decrease operating costs by an amount sufficient to produce a return of 12.25 percent (and perhaps 16.25 percent), they have <u>no</u> incentive to reduce operating costs by an amount that would produce a higher return. The plain result is an overly high-cost telephone network and thus overly high prices for communications service.

[1/] See Policy and Rules Concerning Rates for Dominant Carriers, 5 FCC Rcd. 6786, 6789-90 (1990), Erratum, 5 FCC Rcd. 7664 (1990), recon. 6 FCC Rcd. 2637 (1991), aff'd sub nom. Nat. Rural Telecom. Ass'n v. FCC, 988 F.2d 174 (D.C. Cir. 1993).

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A second feature of the FCC's existing price cap rules keeps prices of service artificially high even more directly. Under this feature, LECs have broad discretion to lower the price of service by a few percentage points since they can do so without substantial documentation. But they have little incentive to reduce prices by large amounts since they must ask the agency's approval for price reductions of more than a few percentage points under a complex legal standard that is hard to meet.[2/] On its face, a rule that complicates the ability of LECs to lower prices by a large amount discourages large price reductions.

While the Commission should retain the core requirement of price cap regulation which mandates that LECs lower prices of service annually in inflation adjusted dollars, it should eliminate the cap on LEC profitability. It also should eliminate the rule that requires LECs to justify large price reductions under a complex legal standard. These two changes will help consumers by giving LECs a larger incentive to deploy cost-cutting technologies in their telephone networks and by giving them a greater ability to lower the price of service.[3/]

Sincerely,

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[2/] The amount by which a LEC may lower prices without the need to meet this high standard is determined by the Service Band Index as defined by the Commission.

[3/] We believe the risks of making these two changes has grown progressively smaller with each passing year because of changed circumstances. For example, the Commission itself has acknowledged that changes in economic factors within the last few years have speeded the growth of competition in the LECs' traditional businesses. Notice of Proposed Rulemaking, supra, at ¶¶ 22, 24. The Commission likewise has acknowledged that many regulatory barriers which previously hampered the ability of companies to compete with LECs have been eliminated during this same period. Id. at ¶ 20.

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